CENTRAL BANK OF KENYA

CBK NEWSLETTER

Keeping you informed

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INSIDE THIS ISSUE

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Word from the Governor

FINANCIAL SERVICES FOR ALL

Ease of access to financial services is a key contributor to a country's economic growth. In realisation of this,Kenya has been making commendable progress in fostering an enabling environment for financial inclusion and deepening financial access to the majority of its citizens. Indeed, the results of the Financial Access (FinAccess) Surveys, conducted in 2006 and 2009 can attest to this. The surveys revealed that the number of unbanked population aged 18 years and above dropped from 23 percent in 2006 to 18 percent in 2009. During the same period, the proportion of adults accessing financial services from Microfinance Institutions (MFIs) and Savings and Credit Cooperative Societies (Saccos) more than doubled, from 8 to 18 percent whereas the proportion of adults accessing informal financial services dropped. In addition, the number of deposit accounts have increased from 4.7 million in 2007 to 12.8 million in 2010. Of these accounts, 11.25 million are micro accounts (Ksh. 100,000 and below are fully covered by DPF). These developments indicate that the initiatives instituted towards broadening and deepening financial inclusion are bearing fruits.

I strongly believe that it was in recognition of our efforts that the Alliance for Financial Inclusion (AFI) chose Kenya to host its inaugural Global Policy Forum (GPF) in Nairobi in September 2009. It was not only an honor to the Central Bank of Kenya to co-host the Forum, but also a sign of confidence in Kenya's budding financial sector. CBK is also the current Chair of AFI's Steering Committee and was further recognized in December 2010 by being invited as a non-G20 partner to join the Global Partnership for Financial Inclusion (GPFI). The GPFI will promote and co-ordinate cross cutting Financial Inclusion efforts in G20 and non-G20

countries.
The Central Bank will continue to promote measures within the law to ensure that financial services reach even more people. The key initiatives that have been implemented include: licensing of MFIs, introduction of agent banking, operationalization of credit reference bureaus, promotion of the use of mobile phone channels, modernization of the national payment and settlement system, to name but a few.These developments are in line with the broader government financial sector policy initiative that hinges on three pillars: Access, Efficiency and Stability aimed at achieving Kenya's *Vision 2030* goals.

The Central Bank in partnership with other players, including AFI and the GPFI, will continue to spearhead appropriate policy reforms and interventions for the financial sector to progress the country towards a more financially included population enjoying the attendant benefits of growth and prosperity for all.

Prof. Njuguna Ndung'u, CBS

‘Kenya: Policies for Prosperity’ Book Launched

His Excellency The President, Hon. Mwai Kibaki, officially launched the volume *‘Kenya: Policies for Prosperity’* on 9th February, 2011 at the Kenyatta International Conference Centre. Speaking at the launch, His Excellency the President noted that the book ‘complements Vision 2030 by evaluating policy options that would ensure a prosperous Kenya, adding that ‘it was a rich source of information, debate and analysis on the challenges and strategic choices confronting Kenya.’

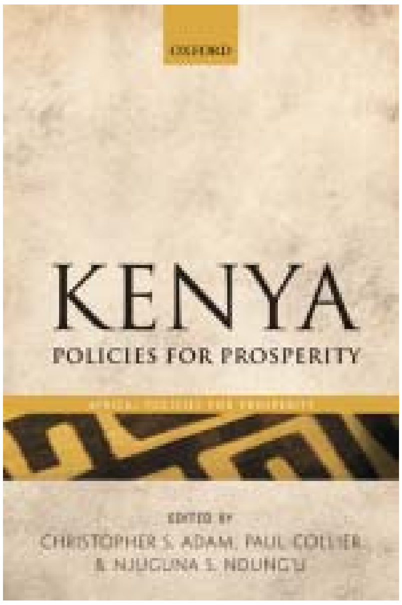
From R to L: His Excellency the President, Hon. Mwai Kibaki poses with the editors of the book, Prof. C. Adam, Prof. P. Collier and Prof. N. Ndung’u during the launch.

‘Kenya: Policies for Prosperity’, a first in a new series *Africa: Policies for Prosperity*, is a collaborative effort between the Central Bank of Kenya and the Center for the Study of African Economies, Oxford University, geared towards developing analytical capacity at the local institutional level as well as providing a variety of policy options that support *Vision 2030*.

The Book’s authors are drawn from a pool of accredited local and international researchers and edited by Central Bank Governor, Prof. Njuguna Ndung’u and Oxford University Professors, Paul Collier and Christopher Adam.

Addressing participants at the Launch, the Governor noted that Central Bank of Kenya had benefited immensely through capacity building and networking with world renowned economists. An important lesson learned, the Governor added, was that ‘collaborative research between policymakers and academics ensures formulation of practical solutions to practical problems.’ Spanning 17 chapters, the Book which draws lessons from Kenya’s recent experiences, focuses on three broad themes namely:- strategic choices that will support growth and unlock the country’s potential; macroeconomic policies including monetary, fiscal and trade policies; and the environment for private sector market activity, including multi-sectoral analysis and the role of institutions in protecting the markets and safeguarding democracy.

The Book, published by Oxford University Press, can be ordered online through www.oup.co.uk or through its local office, Oxford University Press, East Africa Ltd., Nairobi, Tel: 273 20 41/2 – 9.



‘Collaborative research between policymakers and academics ensures formulation of practical solutions to practical problems.’

CBK Releases Draft Electronic Payment Regulations

"Every time you see growth in the market, watch what is happening to the unit cost", the Governor, Prof. Njuguna Ndung'u said during the launch of draft regulations for the electronic retail transfers and electronic money issuers on 3rd February, 2011. The Governor pointed out that usually transaction costs decline when the market grows.

These regulations are intended to ensure that E-Money Issuers and Payment Service Providers conduct their businesses prudently and in accordance with the provisions of relevant legislations including the Central Bank of Kenya Act.

The Governor noted that, in the last four years since the establishment of mobile phone money transfer services, four mobile phone operators have already launched the services and have enrolled over 15.4 million customers. They have recruited 39,449 agents while total transactions have soared to Ksh.2.45 billion a day and Ksh.76 billion a month on average as at December 2010. This depicts a very productive market for electronic money transfers.

Mr. J. Kitili, Director, Banking Services & Risk Management Dept. waves the draft regulations after the launch. Looking on are Messrs D. Porteous, the Governor, Prof. Ndung'u and S. Mwaura .

These Regulations will be reinforced by the National Payments System Bill, currently awaiting enactment by Parliament. This will enable Kenya's payment system to comply with the Bank for International Settlements (BIS) Core Principles and Central Bank responsibilities while at the same time giving CBK specific and enhanced powers over regulation of payment systems in Kenya.

Global Savings Forum

The first global meeting focusing on savings as a function of financial inclusion was held in Seattle, USA on 16th - 17th November, 2010. The forum discussed innovative ways of reaching the poor through banking beyond branches and leveraging on technology.

At the forum, the Governor, Prof. Njuguna Ndung'u, shared Kenya's experiences in promoting financial inclusion through frameworks that balance innovation and safety. He also underscored the role of financial inclusion in creating safe havens for the poor to save, accumulate assets and uplift their living standards.

Also at the forum were heads of government, representives from banks and technology providers as well as international development bodies .

Launch of GPFI in Seoul, Korea

The G20 Global Partnership for Financial Inclusion (GPFI) was launched in Seoul, Korea on 10th December 2010.

The formation of the GPFI was one of the key resolutions by G20 leaders at the November 2010 Seoul Summit to promote financial inclusion particularly for poor households and Small and Medium Enterprises. CBK was invited to become a non-G20 partner of the GPFI.

At the launch, Governor, Prof. Njuguna Ndung'u delivered a speech on behalf of non-G20 partners of the GPFI. In his remarks, the Governor said "I am sure that the GPFI will serve as a highly effective platform unfolding the convening power of the G20 and encouraging the G20 and non-G20 members together to take global financial inclusion to the next level".

The Dawn of Currency Centres

In the Kenyan context, a Currency Centre is an establishment set up to provide currency services to the population around it. These centres are set-up by the Central Bank of Kenya in conjunction with the Kenya Bankers Association.

The need to introduce currency centres resulted from the desire to minimise risks of currency transportation and to cut down on operational costs which would be passed on to customers. The creation of Currency Centres therefore means that commercial banks do not have to transport cash over long distances to the four CBK locations of Nairobi, Mombasa, Kisumu and Eldoret Branches as often as they did in the past. Further, the establishment of the currency centres is expected to support the Central Bank's clean money policy which aims at ensuring that currency notes in circulation in the country is clean.

The pioneer Centre in Nyeri which was set up in December 2009 has seen the number of banks using the facility steadily grow from one in January 2010 to twelve by December 2010. Volume of transactions has also been on the rise and currently about 7 percent of all CBK's physical currency transactions with commercial banks are in Nyeri. Data available at CBKindicate that more deposits than withdrawals (negative currency in circulation) occur in the Nyeri region and therefore the Centre is a perfect choice of catchment for old currency.

The second of these Centres was opened in Nakuru on 16th December 2010 and has since been providing cash requirements to at least five commercial banks in Nakuru and its environs. The currency centre is intended to serve the 23 commercial banks and their branches represented in the Nakuru region.

Prof. Ndung'u plants a tree at the newly opened Nakuru Currency Centre. Banks are expected to translate the benefits from lower transaction costs into cheaper credit and better service delivery.

CBK and KBA are currently working on finalising the set up of a third currency centre in Meru. Currency centres apart from providing currency services to the population, also work towards achieving the objective of financial inclusion through reductions in transaction costs associated with provision of financial services.

Let Credit Information Work for You

Credit Information comprises a person's history relating to borrowing from lenders. Credit information sharing, in the Kenyan context, therefore refers to the exchange of customers' credit information amongst institutions, licensed under the Banking Act, through licensed Credit Reference Bureaus (CRBs). The lenders submit customers' credit information to the licensed CRBs who collate it and generate credit reports, which are then made available to the lenders, at a fee, for their use when appraising applications for credit facilities. Credit information sharing reduces the incidence of non-performing loans by reducing lack of information on customers and facilitates borrowing particularly by Small and Medium Enterprises (SMEs). SMEs can use the information capital held by CRBs as collateral for loans as opposed to the traditional use of physical collateral such as land title deeds and motor vehicle log books.

Following the launch of the banking sector Credit Information Sharing initiative in Kenya on 31st July 2010, all lenders were required to submit data on NPLs to licensed CRBs on a monthly basis. As at 31st December 2010, one CRB, CRB Africa had been licensed and the application for the second one, Metropol CRB was at advanced stages of review. The total number of credit reports submitted to CRB Africa since rollout was 3,102,735 and credit reports requested by the banks and customers were 284,722 and 434 respectively. The CRB regulations place strict restrictions on the use and application of confidential information. CRBs and banks are prohibited from sharing information with unauthorized third parties. The penalty admissible for breach of confidentiality is Ksh.500,000 and Ksh.1 million for CRBs and banks, respectively.

Moving forward, the CBK in partnership with Kenya Bankers Association and other players will endeavor to ensure that the credit information sharing mechanism is not only robust but is also extended beyond the banking sector to include other credit providers such as Deposit Taking Microfinance Institutions, SACCOs, Development Finance Institutions and Utility Companies, among others. It is only when all credit providers are part of the credit information sharing mechanism that the potential benefits of credit information sharing will be optimized.

NEWS IN PICTURES

CBK Directors wait for the Chief Guest at the CBK stand during the Nairobi International Trade Fair in September, 2010

From L - R: Ms J. Ikunyua, Asst. Director, DPFB, Evelyn Kilonzo (BSD) and Mr. N. Koome (RBA) listen keenly to presentations at the Financial Education Strategy retreat organized by the Financial Education and Consumer Protection Partnership (FEPP) held in Naivasha in October 2010.

Prof. Njuguna Ndung'u (centre) and other dignitaries at the 2nd AFI Global Policy Forum in Bali, Indonesia.

Business editors of local media houses listen keenly to proceedings during their meeting with the Governor, Prof. Ndung'u to discuss expansion of Financial Literacy in the country.

Some members of staff from Reserve Banks of Malawi and Zambia on a Financial Education tour in Kenya. The group visited a Pilot Project organised by Faulu Kenya in Kayole, and funded by FSD.

The Governor, Prof. Njuguna Ndung'u (seated right) and CBK Bank Secretary, Mr. K. Abuga sign the Memorandum of Understanding (MOU) for the collaboration of Financial Sector Regulators, on 31st August, 2009.

Financial Inclusion

The Bridge To Growth And Prosperity

Most poor people in the world lack access to sustainable financial services and the challenge to Governments is normally how to address the constraints that exclude people from full participation in the financial sector. In the last few years, a number of international development organizations as well as policymakers in developing countries have been increasingly emphasizing the need to build more inclusive financial systems as an essential part of the development agenda.

According to the United Nations, the bottom billion people around the world do not have access to formal financial services like savings accounts, credit, insurance, and payment services. Further, more than half the population in developing countries and more than 80 percent of households in most of Africa are financially excluded. Financial inclusion therefore aims at providing timely delivery of various financial services at an affordable price to these financially excluded households and micro, small, and medium-sized entrepreneurs. Through increased access to savings accounts and other financial services, the poor can build financial security, manage risks against adverse shocks such as illness or natural disaster, and even invest in new business opportunities. Improving access to finance also plays a crucial role in promoting economic growth and reducing poverty.

Improving financial access

It is worth noting that microfinance was an initial effort to reduce poverty by improving access to finance for the poor. Microfinance Institutions (MFIs) usually extend small loans to the poor who have no collateral or credit history and cannot borrow from mainstream financial institutions. However, microfinance alone cannot expand financial access for the poor and therefore building an inclusive financial system is a more comprehensive effort towards financial inclusion. This effort emphasizes that formal financial institutions such as banks have an important role to play in expanding financial access to the poor. It also stresses the importance of governments' role in creating a proper environment to facilitate increased financial access.

Women sew clothes at a local industry funded by SMEs through loans

Photo by NMG

A well-functioning financial system is a crucial part of development,promoting economic growth and reducing poverty. Financial institutions and markets mobilize savings, provide payment services, allocate resources and transform risk by pooling and repackaging it. When a financial market functions well, funds will likely be allocated to the most productive users, which will contribute to economic growth and poverty reduction. However, when the market does not function properly, it loses growth opportunities.

A financial system becomes more efficient and functions better when it is more inclusive. As a financial system becomes more inclusive, it provides more growth opportunities to more individuals and entrepreneurs. However, when the financial system serves only a limited segment of the population, the society is likely to lose opportunities to grow.

Barriers to financial access

In order for policymakers to understand the impact of access to financial services and design effective policies to improve access, it is important to measure access and identify the barriers to access. Identifying these barriers is an important part of measuring access. Major barriers include limited geographical access to a bank, lack of appropriate documents (e.g., drivers licenses), and account fees of minimum balance requirements.

By having access to financial services, poor households obtain reliable tools for managing their money. Since the incomes of poor households are unstable, their need for reliable financial services is greater than that of richer households. On the other hand, when a firm has access to external finance, it is likely to grow faster. Moreover, by having access to finance, small firms can allocate assets more efficiently, and can increase innovation. By contrast, when small firms face difficulties in obtaining external finance, they lose opportunities to grow and innovate.

Governments can contribute to improving access to finance through appropriate policies and legislation. However, experience suggests that not all government policies are helpful and governments' direct intervention could be counterproductive. Although reforming institutions and building infrastructure can take a long time, governments can improve access to finance relatively fast by prioritizing certain institutional reforms and focusing on specific infrastructure. In particular, reforming information infrastructure such as building credit registries and improving debt recovery procedures tend to generate fast results in improving access to finance. It is noteworthy that governments can improve access by providing legislation and regulations that would allow market participants to use innovative technologies (e.g., the Internet and cell phones) to reduce the cost of providing financial services significantly.

Mobile phone banking

While banks invest substantial amounts of money for infrastructure and personnel under the traditional branch-banking approach, mobile phone banking allows banks to provide financial services at reduced costs. Kenya's mobile phone payment services is a good example of how using modern technology with government's supportive policies and proper regulation can provide financial services to millions of poor people at low costs. (The government's appropriate policy actions made this impressive success possible). First, the government created a favorable environment to expand the mobile phone market. Second, it engaged the private sector in its policy-making process to make sure that government will provide support for service providers and to evaluate possible risks to financial stability. Third, the government strategically chose to allow technological innovations before enacting appropriate legislation in order to expand access to finance.

Allowing new products into the market in the absence of relevant legislation may compromise financial stability. However, the government successfully balanced access with stability by carefully monitoring the market and enhancing oversight capacity to ensure that financial stability was maintained.

Governments can also improve access by facilitating competition. As competition intensifies, incumbent financial institutions are likely to extend services to new markets and try new, cost-effective technologies in an effort to find new ways to increase profits. However, it is also important to make sure through regulatory measures, that intense competition would not result in reckless and improper lending practices.

Client withdraws money from an ATM using mobile phone.

Photo by NMG

While governments' role in creating an appropriate environment to facilitate access is important, the scope of their direct intervention is limited, and direct intervention programs require careful monitoring.

Ref: http://www.uiowa.edu/ifdebook/faq/faq_docs/Financial_Inclusion.shtml

Financial Inclusion explained

Q: What is Financial Inclusion?

Ans: The Centre for Financial Inclusion defines Financial Inclusion as a state in which all people who can use financial services have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients. Financial services are delivered by a range of providers, most of them private, and reach everyone who can use them, including disabled, poor, and rural populations. However, according to the World Bank, nearly three billion people in developing countries have little or no access to formal financial services that can help them increase their income and improve their lives.

Q: Why Financial Inclusion?

Ans: Financial inclusion aims at drawing the "unbanked" population into the formal financial systems so that they have the opportunity to access a variety of financial services ranging from credit, savings and payments to transfers and insurance services. In addition, according to the United Nations, in order to achieve the objective of economic growth, it is imperative that infrastructure is developed together with increased financial inclusion. A country cannot tackle poverty and foster economic growth when the majority of its people have limited access to financial services. Therefore, to achieve equitable economic growth and development, it is necessary that the majority of a nation's people have access to appropriate and affordable financial services and products in order to enhance their quality-of-life and ultimately economic development.

Q: What is the Central Bank doing about Financial Inclusion?

Ans: In recognition of the importance of financial inclusion towards realisation of desired economic growth and poverty alleviation, the Central Bank of Kenya and other players have undertaken several policy and regulatory reforms aimed at enhancing the level of financial inclusion in Kenya. The key initiatives which have been implemented to this end include:-

- The licensing of deposit taking microfinance institutions, whose primary focus is the low income households and Small and Micro Enterprises, that are concentrated in the rural and peri-urban areas. CBK has granted licences to Faulu Kenya, Kenya Women Finance Trust, REMU and SMEP to carry out nationwide deposit-taking microfinance business. UWEZO DTM has been licensed to offer community microfinance services in Starehe Division, Nairobi.
- The implementation of the Agent Banking Guidelines in May 2010 allowed Commercial Banks to partner with third parties like shops, petrol stations and chemists to offer specified banking services on their behalf. This is aimed at increasing the outreach of banks to most corners of the country at a reasonable cost and without compromising the quality of banking services. Six banks have been granted approval to rollout their agency networks.To date the Central Bank has approved over 6,000 agents.
- The licensing of CreditReference Bureaus, which provide an opportunity for individuals and businesses to rely on their good credit history as an alternative form of collateral, unlike the traditional physical collateral, to secure credit facilities from banks.
- Promotion of the use of technology enabled financial services using platforms such as M-pesa, Zap, Pesa-pap and YuCash.
- Promotion of consumer education and awareness campaign initiatives in order to enhance financial literacy. CBK is a member of the Financial Education and Consumer Protection Partnership whose objective is to develop a comprehensive National Strategy for Financial Education for Kenya.
- Amendment of the Banking Act to include provisions that permit banks to launch innovative products that serve the diverse needs of the Kenyan populace. These include amendments that facilitated Shariah compliant banking and the operation of current accounts by mortgage finance companies.

Changes in Perceptions of the Economy:
The Monetary Policy Committee (MPC) Market Surveys

Since September 2009, the Monetary Policy Committee (MPC) has been conducting bi-monthly market surveys. This idea arose from interactions with monetary policy committees in other countries. Those committees had benefited from informal surveys which provided insights into the business communities' perceptions with respect to various significant macroeconomic aggregates.

Initially, the survey instrument only covered the commercial banks but by December 2009, it extended to cover private sector non-bank firms. Initially, also, the commercial banks did not regard the survey seriously and hence did not provide adequate and consistent answers to questions. This was observed both from the extent of coverage of the banking sector and from the designation of the officers completing the questionnaire. This soon changed when the banks realised that the MPC was serious in its analysis of the questionnaire, pointing out internal contradictions and hence misleading information. The next major improvement in coverage arose from the bi-monthly meetings of the MPC being held in the CBK's branches. The branches then undertook to assist in accessing the business community in Mombasa, Kisumu and Eldoret.

The major areas of interest obviously were inflation and economic growth expectations. These two areas particularly, relate to the MPC's mandate in managing inflation and supporting economic growth. At a secondary level, the health of the Kenyan currency internationally, as depicted by strengthening or weakening of the Kenya Shilling against the US dollar, was also of interest and hence expectations in this area were also elicited. Clearly, the way in which growth is enhanced and inflation is controlled arises from movements in interest rates and private sector credit. Expectations with respect to these two were also surveyed.

At a secondary level, the health of the Kenyan currency internationally, as depicted by strengthening or weakening of the Kenya Shilling against the US dollar, was also of interest and hence expectations in this area were also elicited.

Governor adressing press after the Monetary Policy Committee meeting in January 2011

The survey implicitly was based on a market for private credit since potential crowding out by government borrowing was seen to be a threat by the private sector. It was at this point that the interaction between the banks, as potential lenders, and the non-bank private sector firms, as the potential consumers of credit, were analysed. If both the banks expected to expand lending and the non-bank private sector to expand borrowing, then expectations with respect to changes in interest rates could tell whether the quantitative expectations were likely to be frustrated or fulfilled.

The eight surveys which have been conducted also allow the MPC to see in what way perceptions and expectations have been revised. Initially, in September 2009, most of the banks foresaw a rise in inflation but by November 2010, the majority had reviewed their projections. Much the same story can be told with respect to the non-bank private sector. The growth expectations story is even more spectacular, 68 percent of the banks considered a 2-3 percent growth in 2010 as likely, now, over 80 percent have forcast= a 5 percent growth as most probable. Once again, the non-bank private sector has shown the same expectation. Perhaps not changing their minds, but that once more information was made available, the conclusions and expectations changed.

When one looks at the responses with respect to interest rate expectations, which has been the key variable of interest to the MPC, the commercial banks initially expected rates to fall and then as they brought them down they reported revised expectations that they would remain stable, suggesting a slower rate of reduction in the interest rates. These gradual rate declines, which were noted in both base rates and lending rates, were associated with an expectation of an over 10 percent increase in private sector lending. This coincided more or less with what the private sector foresaw as their demand.

This bi-monthly survey is a live instrument and the questionnaire is constantly improving. It has allowed the MPC to talk to the CEOs of banks and, on the basis of their own submissions – the forms are now being filled by very senior bank officials – question their interest rate spread and exchange rate forecasts.

Table 1 shows that expectations for higher economic growth in 2010 and a strong exchange rate have been maintained. Generally, inflation has been expected to remain low and stable for the remainder of 2010. But the proportion of respondents who are expecting inflation to rise has continued its upward trend since January 2010. Similarly, Table 2 shows that non-bank private sector firms have maintained their expectations for higher economic growth, low and stable inflation, and a strong exchange rate. A lower proportion anticipates an increased demand for credit. Overall, these surveys have enabled the MPC to track the improvement in confidence in the performance of the economy.

In conclusion, the one success that the MPC has had in the market is to coordinate expectations. This has allowed the market to process information provided correctly and also to understand this vital subject of monetary policy, and its transmission mechanism to the economy.

Table 1: Changes in Perceptions/Expectations (% of Banks)

	Inflation			Ksh/USD Exchange rate			Economic Growth %				
	Increase by 1-2%	*Remain at the same level*	*Decline by 1-2%*	*Strengthen*	*Remain the same*	*Weaken*	*2-3*	*3-4.4*	*4.5-5*	*5*	*Above 5*
Sep - 2009	60	24	16	48	28	24	68	24			
Nov-2009	33	30	37	45	48	7	56	22			
Jan-2010	14	45	41	50	32	18		41	59		
Mar-2010	15	60	25	50	32	18		40	60		
May-2010	16	44	40	24	20	56		24	76		
July-2010	25	62	14	21	28	51		17	69		14
Sep-2010	38	44	18	68	9	23		9	82		9
Nov - 2010	42	46	12	61	33	6		3	12	39	46

Table 2: Changes in Perceptions/Expectations (% of Non Bank Private Sector)

	Inflation			Ksh/USD Exchange rate			Economic Growth %					Demand for Credit			
	Increase by 1-2%	Remain at the same level	Decline by 1-2%	Strengthen	Remain the same	Weaken	2-3	3-4.4	4.5-5	5	Above 5	Decline	Remain the same	Increase by 1-10%	Increase by 10-20%
Sep-2009	60	24	16	48	28	24	68	24							
Nov-2009	20	20	60	22	78		90	10							
Jan-2010	18	64	18	30	40	30		73	27			17	17	66	
Mar-2010	38	52	10	19	48	33		86	14				33	17	50
May-2010	45	18	37	28	43	29	5	53	33		9	15	30	25	30
Jul-2010	28	28	44	26	21	48		17	66		17	7	33	33	27
Sep-2010	42	32	26	42	21	32	16	21	63			7	47	46	
Nov-2010	35	36	29	61	33	6			19	50	31	23	46	23	8

First Monetary Policy Forum

The inaugural Monetary Policy Forum was held on 10th August, 2010 at the Kenya School of Monetary Studies. The Forum, organised by the Central Bank of Kenya (CBK) and Kenya Bankers Association (KBA), brought together key stakeholders from the public sector, media, academia, research institutions, and financial and real sectors to discuss monetary policy issues, banking sector developments, financing of private sector activities and also develop public awareness on financial services. It also provided a platform to obtain feedback on the impact of monetary policy decisions by the Monetary Policy Committee (MPC) on commercial banks and the real sector. The theme of the Forum was "Lubricating the Economic Engine with Adequate and Affordable Credit".

In his opening remarks the Governor, Prof. Njuguna Ndung'u said such public forums provide important avenues for bringing together key stakeholders to discuss how monetary policy affects them, to learn about banking sector developments and the opportunities they present. "In addition, he said such a forum helps in the understanding of how finance supports private sector activities and sensitizes the public on the range of financial services".

Stakeholders agreed that in order to achieve the objectives of the Forum and in view of the current favourable macroeconomic conditions, and improved liquidity conditions following easing of the monetary policy stance by the MPC, commercial banks should lower their lending rates further to enhance credit uptake by the private sector. The high cost of credit was highlighted by the private sector as a key obstacle for the sector to contribute fully to the country's growth target. It was also observed that credit uptake by the private sector could be enhanced by increasing access to financial services. Commercial banks were encouraged to be more transparent by disclosing the level of bank charges to the public.

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The Kenya Government Bond Program and Market Development

Over the years, the Central Bank of Kenya in liaison with stakeholders in the financial sector has put in place a number of key initiatives that have seen tremendous growth of Kenya's bond market. The Bank has worked closely with the Market Leaders Forum (MLF), a consultative group consisting of among others securities dealers, investment bankers, Treasury, the Central Bank and the Capital Market Authorities.

To begin with, lengthening of the maturity of securities in the domestic debt portfolio was the initial task to be accomplished. Prior to 2002, government domestic debt component of public debt consisted mainly of short term instruments, a source of significant refinancing risk. In fact, the composition of Treasury bills to bonds

The on-going construction of Thika Road, Nairobi, funded by proceeds from the infrastructure bond.

Photo by NMG

in the portfolio stood at 70:30. This necessitated formulation of a deliberate policy action to restructure the portfolio by lengthening the maturity of instruments thus substantially minimizing refinancing risks associated with short-term debt and contributing to development of a vibrant secondary market for bonds. Certain reforms were introduced to create demand in long term bonds including the lowering of the cash ratio for commercial banks to release liquidity thereby reducing short term interest rates, streamlining the domestic Borrowing Cash Plan in favour of bonds and the liberalization of the pension sector.

The process began with the phased introduction of medium to long term bonds in the market, a step that saw successful issuance of bonds of up to 15 years maturity before 2008 and the first 20-year in June 2008. Indeed, the first 25-yr bond offered to the market in June 2010 and reopened a month later received very positive market uptake. In February 2011, the CBK successfully issued the longest bond in the market, 30 year, dubbed 'Savings Development Bond' (SDB). As a result of this effort, the ratio of Treasury bills to bonds in the debt portfolio has since reversed from 70:30 in 2001 to 23:77 so far while average maturity of all securities in the portfolio grew from about 8 months in 2001 to 5 years 4 months by February 2011. This development is a perfect reflection of market maturity and successful achievement of the initial objective set out in the pursuit of bond market development.

The issuance of medium to long term bonds also provided the much needed impetus to develop a liquid bond market and a reliable yield curve, a key benchmark tool for guiding future issuances of financial securities as well as pricing other financial products like corporate bonds, mortgages and commercial loans.

Milestones

Building on the growth of the bond market achieved from the foregoing, the Central Bank of Kenya together with the MLF adopted and began the implementation of benchmark bonds program to improve liquidity at the secondary market and firm up the yield curve. Benchmark Bonds are securities characterized by high credit quality, least default risk, and reasonably large in volume. They are generally highly liquid, have most depth i.e. most widely held by various investors, have the narrowest bid-offer spreads, preferably lowest yield and therefore carry the potential of active trading in the secondary market.

Benchmark bonds are bonds against which other securities or interest rate products are priced or referenced. Consequently, benchmark issues form the basis for deriving a benchmark yield curve. The programme which took off in 2007 began with the identification and adoption of 2, 5, 10, 15 and 20 year maturities as benchmark tenors for issuance along the maturity spectrum. The implementation of the programme entailed issuance of large size bonds of tenors identified in order to build liquidity and promote robust secondary market trading. The Bank has consistently and successfully issued bonds in these tenors and employed strategies identified in the programme to ensure build up of liquidity around each bond issued.

One of the strategies that have received notable market support since inception in April 2009 is the reopening of benchmark bonds to increase both the volumes and the holders for enhanced trading. Bond reopening involves increasing the outstanding amount of a previously issued bond. It involves offering additional amounts of the same instrument, which bears the same features of an existing outstanding bond, except for the issuance date and possibly, the offer price or yield. About 9 bonds have been reopened so far with all reopening auctions oversubscribed.

Active secondary bond market is critical for successful mobilization of domestic resources by government through borrowing and to investors as an exit mechanism in accordance with their investment preferences. Other strategies in the pipeline under the benchmark bonds programme include but not limited to conversions, switches/exchanges, consolidations and potential buy-backs. These strategies are aimed at eliminating the fragmentation problem in the market where small illiquid bonds are retired or switched to benchmark bonds to build liquidity and enhance trading. Another milestone that has contributed to market growth to levels seen today is the introduction of new products aimed at diversifying the range of products from the conventional treasury securities for market deepening and development. In FY2008/2009 budget speech, the Government began to tap into the bond market to finance infrastructure projects that require huge capital outlay for long term funding and as a way of promoting public accountability and transparency on the use of proceeds from long term project specific bonds.

In February 2009, the government through the CBK launched the first ever Infrastructure bond (IFB) to finance key economic and social infrastructure around the country. This bond was very successful attracting 145% subscription which was a reflection of huge market buy-in and sense of patriotism by the citizenry in ownership of the country's development agenda.

Geothermal energy: One of the projects to benefit from the proceeds of Infrastructure Bond.

All other IFBs issued so far were oversubscribed with the last single issue of Ksh 31bn in August 2010 taken up at 118% subscription. In taking this move, government set a precedent for other public agencies and private sector to make use of the strength of their balance sheets and tap into the local capital market to raise funds to finance their long term projects through issuance of infrastructure bonds. The Kenya Electricity Generating Company (KenGen) was one such entity that took up the challenge and successfully issued its first Ksh 25b Public Infrastructure Bond (PIBO) in November 2009 which was heavily oversubscribed.

Benchmark bonds are bonds against which other securities or interest rate products are priced or referenced.

In recognition of market maturity as a reflection of ability to process available information for price discovery, the CBK recently started the issuance of market determined coupon bonds (as opposed to preset coupon bonds) beginning with maturities up to 10 years. This move has helped minimize the costs associated with bonds servicing by government, created an opportunity for price discovery and promoted market efficiency.

In diversifying the range of products, the Bank also introduced the 364-days Treasury bill in August 2009. This paper has not only added to the range of money market instruments but also promoted development of the money market yield curve and as a benchmark for pricing one year money.

It has attracted great popularity mainly from the commercial banks. In providing investment products to the retail sector, the government through the CBK launched the debut 30-year Savings Development Bond (SDB) in February 2011 aimed at promoting a savings culture among the Kenyan population in line with the tenets of Vision 2030, which was received with a lot of success. In addition, the bond was a platform for stimulating personal economic empowerment by providing an alternative investment instrument that is safe and secure while delivering solid and dependable returns.

The issuance of the 30-year SDB came at an opportune time when Kenya had entered into a new constitutional dispensation which reflects fortifying public confidence and contribute towards determining the country's future growth and economic development.

At the secondary market level, key initiatives undertaken include the Introduction of Automated Trading System (ATS) for Treasury bonds in November 2009 that saw increased trading of bonds as a result of market efficiency and confidence. Transaction cycle was in effect reduced to T+3. Annual bonds turnover at the NSE increased from Ksh 108Bn in 2009 before introduction of ATS to Ksh 484Bn in 2010, after the implementation of the ATS.

Investing in government Securities - Central Depository for Government Securities (CDS) Account a key prerequisite.

It is a requirement that those who wish to invest in Government Securities open a CDS account at the Central Bank of Kenya (CBK-CDS) or at its branches and currency centres. Investors outside Kenya can open CDS account as nominees through CBK authorized agents including commercial banks, stock brokers, investment banks and advisors licensed by the Capital Markets Authority.

Opening a CBK-CDS account is free of charge. In order to invest, investors MUST fill in application forms for preferred bonds or Treasury bill (available on http://www.centralbank.go.ke/securities/ApplicationForms.aspx) or from the Head office in Nairobi or branches in Mombasa, Kisumu or Eldoret or at any the currency centres in Nakuru, Meru and Nyeri. CBK has also partnered on a pilot basis with five commercial banks namely Kenya Commercial Bank, National Bank of Kenya, Equity Bank, Co-operative Bank of Kenya and Kenya Post Office Savings Bank to facilitate the opening of CDS accounts and placing of applications for Treasury bills and bonds.

What others said about Infractructure Bonds...

"The future is very bright for two reasons: they enable the government to raise long-term funds which will help implement several projects that are envisaged in the *Vision 2030*. Secondly, it offers savers attractive interest rates therefore being an excellent investment opportunity".

Mr. James Murigu, Director, Metropol Africa

"Market players actively participated in explaining to the market, via the media, the rationale for the infrastructure bonds, demystifying the bond and technical terms associated with them. This third-party endorsement by market players was critical in getting public to buy-in, creating an anticipatory and positive sentiment around the issues, and in keeping the issue firmly in the public eye".

John Ngumi,
Investment Banking Director,
CfC Stanbic Bank Ltd.

"Is there investors' appetite for the infrastructure bonds? The first infrastructure bond of Ksh.18.5 billion issued in February 2009 was oversubscribed by 45 percent while the second issue of Ksh.18.5 billion in December 2009 was oversubscribed by 138 percent. In March 2010, the government issued Ksh.14.5billion. This was oversubscribed by 143 percent. In August 2010, the government offered Ksh.31.6 billion that was oversubscribed by 18 percent. Considering the significant investor participation in those issues, it is clear that the infrastructure bond is very popular with investors and will continue being a preferred investment avenue".

Mr Peter Wachira, Senior Investment Manager, Pinebridge Investments

"By issuing Infrastructure Bonds, the Government took the first step in setting a benchmark for other issuers to come into the market. This has created public awareness on alternative investment channels thus deepening the capital markets. Safaricom and Kengen issued their first public Infrastructure Bonds to a resounding success, an indication of a ready market for the Bonds and the priority granted to infrastructure by the public. The Government recognizes that capital markets play a pivotal role in raising capital through a well developed bond market to meet increasing demand of infrastructure development from both the private and public sectors. Bonds also act as a pricing benchmark for similar bonds issued by other public and private sector players. As a way forward, it is expected that the Bond program will continue with enhanced participation of more public entities".

Mr Charles Kairu, Senior Economist
Ministry of Finance

From L-R: Mr. S. Makove, CEO, IRA; Prof. N. Ndung'u, Governor, CBK; Mr. J. M'Igweta, Chairman, RBA, Mr. M. Cheserem, the then Chairman, CMA; Mrs. S. Kilonzo, CEO, CMA; Mr. E. Odundo, CEO, RBA and Mr. S. Mainda, Chairman, IRA, respond to journalists after signing the Memorandum of Understanding on 31st August, 2009.

Financial Sector Regulators collaborate

The regulators of the Kenyan financial sector stepped a level higher to formalize linkages among them. This includes sharing information and developing more effective approaches of dealing with issues of mutual interest within the sector. These issues include supervision of players, registration and licensing of players, consumer protection and compensation, research and capacity building.

Currently, there are five independent sectoral regulators in the Kenyan financial sector, namely; the Central Bank of Kenya (CBK) oversees the banking sector, the Capital Markets Authority (CMA) supervises the capital markets, the Retirement Benefits Authority (RBA) manages the pensions and other forms of retirement schemes, the Insurance Regulatory Authority (IRA) runs the insurance sector and the newly established SACCO Societies Regulatory Authority (SASRA) oversees SACCOs with Front Office Service Activity (FOSAs)

Need For Collaboration

Though the regulators have previously shared information and collaborated on a need-to basis, there was no formal agreement supporting their collaboration. It is with the realization that collaboration can assist in the effective performance of their respective duties of promoting a safe, sound and stable financial system that CMA, CBK, IRA and the RBA entered into a Memorandum of Understanding (MOU) on 31st August 2009.

Further, the response for continued convergence among the players in the financial sector became inevitable with the recognition that risks emanating from either of the sub-sectors has the potential to affect the safety, soundness and stability of the entire financial sector.

In addition, the importance of collaboration between financial sector regulators was reinforced by the recent global financial crisis which was partly blamed on loose regulation of players heavily involved in financial innovation and having cross sector operations.

The MOU formed the basis of strengthening the financial sector regulators' collaboration in the cross-sector supervision of financial institutions and cooperation in other matters of mutual interest. Currently, plans are underway for SASRA to be a signatory to the MOU.

A glimpse of the financial regulators 'village' during the joint participation at the Nairobi International Trade Fair.

"Individual commitment to a group effort - that is what makes a team work, a company work, a society work, a civilization work".

Vincent Lombardi

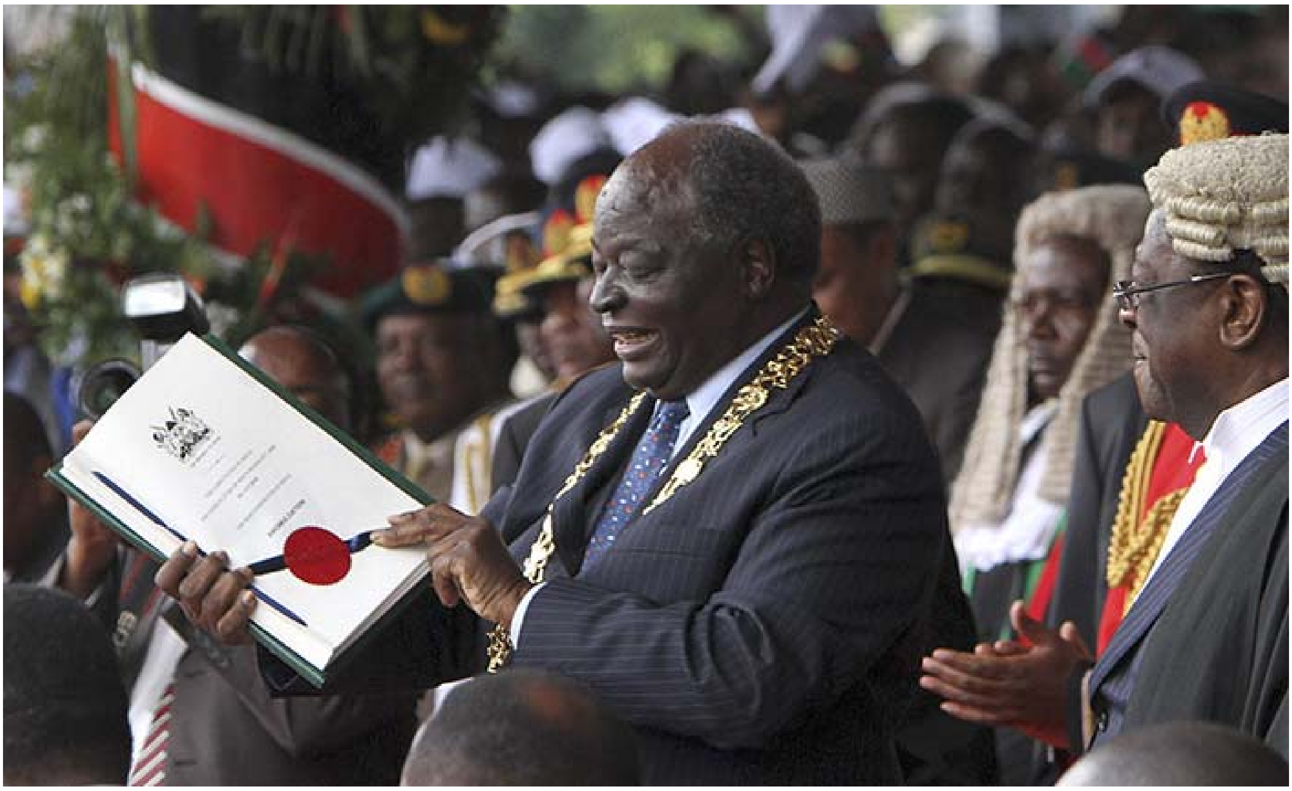
Achievements

Since the signing of the MOU, the financial sector regulators have realized some key achievements. These include secondments and attachment of staff amongst the regulators for knowledge exchange and capacity building; amendment of the respective legal frameworks to support the collaboration; harmonization of financial sector licenses to expire on 31st December of each year and joint participation at the Eldoret, Kisumu, Mombasa and Nairobi Agricultural Society of Kenya (ASK) Shows.

All the regulators have since joined the Financial Education and Consumer Protection (FEP) spearheaded by the Financial Sector Deepening Trust (FSD) Kenya with the ultimate aim of developing a National Strategy on financial education for Kenya; The regulators hold semi-annual Joint Board of Directors Retreats during which the directors of the four regulators review progress in the collaboration efforts and decide on their action plan.

Central Bank and the New Constitution

The morning of 27th August 2010 ushered in a new dawn for Kenya. At exactly 10.27 a.m., thousands of Kenyans gathered to witness the promulgation of a new Constitution. Kenyans had earlier approved the Instruments of Promulgation through a peaceful Referendum held on 4th August 2010.



The President declaring Kenya's New Constitution *Photo by PPS*

With the thousands in attendance looking on, President Mwai Kibaki signed the Instruments of Promulgation and declared Kenya's new Constitution operational.

So what is new for the Central Bank?

The New Constitution has brought with it a number of positive elements for the Central Bank, as contained in Article 231 of the new law.

Perhaps the most prominent provision for the Bank is that the new supreme law has re-established the Bank as a constitutional institution. This is significant because it has created a new sense of perpetuity for the Bank, given that constitutional bodies are not easy to decimate. The provision has also underscored the premier status of the Bank as a national institution.
The new Constitution has emphasized on the independence of the Bank. The new independence is laudable as international best practice favours full independence of Central Banks.

The new Constitution has further restated the core functions of the Bank thereby insulating the Bank from the risk of political interference. This is unlike before, when the functions were only placed in an Act of Parliament that is easy to amend.

Another major development in the new Constitution relates to the features of currency notes and coins. Going forward, the new law allows currency notes and coins to bear images that depict Kenya or an aspect of Kenya but not the image of any individual. Your wallets will therefore soon host refreshed visitors featuring natural and man-made symbols of the nation but steering clear of human images.

In effect, the new Constitution has placed the Central Bank on an elevated pedestal that can only serve to enhance attainment of its statutory mandate and in turn spur economic development in the country.

Evolution of the Kenyan Currency

The Kenyan currency has a long history. In Africa and the rest of the world, in the olden days, trade was carried out by a barter system. This was considered a reasonably efficient method when mostly basic necessities were exchanged. Goats or sheep, for example, were exchanged for grain or in the case of people from Ukambani who exchanged honey for food grown in the highlands of Mt. Kenya. Thriving of the barter system of trade was predominantly dependant on the availability of goods for goods.

The system later developed to the use of cowrie shells and beads. Cowrie shells were rare ornAamental artefacts and therefore formed a sustainable quality product for exchange. The same case applies to the

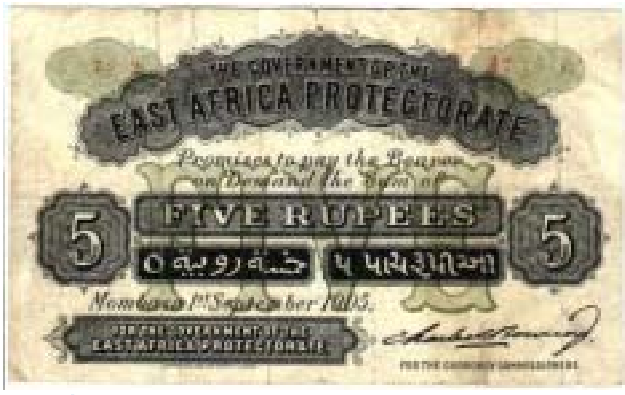
Some of the items used in barter trade

beads which were greatly desired among the Kenyan communities.

The entry of what is commonly considered as real currency in Kenya can be traced back to 1800 - 1850 when the Maria Theresa Thalers were introduced in the Kenyan coast. The Thalers were famous silver coins used around the world in the 18th and 19th Century and used by Indian, Greek and European merchants at the Eritrean and Kenyan coasts. The first Thalers were minted around 1741 and named Thalers after the beautiful Empress Maria Theresa who ruled Austria, Bohemia and Hungary (Austrian Empire) from 1740 to 1780. The Thaler was the most popular and only acceptable silver currency among the Arabs.

1850 Maria Theresa Thaler

Despite the Thaler's popularity in the East African Coast, it was not able to penetrate upcountry and the Indian Rupee was used for payment of Indian workers during the building of the Kenya-Uganda railway in 1896 and managed to move inwards becoming acceptable by the African population who in various mother tongues called it different names such as "Rupia" or "Pesa".



1905 Five Rupees

The Indian Rupee was abolished after Kenya became a crown colony in 1920 when the Imperial British East Africa's (IBEA) mandate was terminated.

The East African Currency Board (EACB) was then established to oversee the issuance of currency in the region, which saw the introduction of the East African Florins.

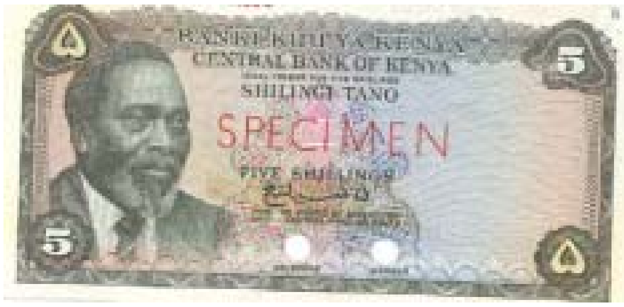
1920 One Florin Coin

In January 1922, the shilling equivalent was introduced in all the three East African countries and by June 1923, the shilling was firmly established as official currency in Kenya, Uganda and the then Tanganyika.

Kenya began printing and minting its own currency in 1966 under the mandate given to the Central Bank of Kenya that was established in the same year.

1921 EACB 100 Shilling Note

The initial issue of Kenya shilling notes were in the denominations of 5, 10, 20, 50 and 100 shillings, all bearing the portrait of the First President of Kenya, H.E. Mzee Jomo Kenyatta in the front, and diverse scenes of economic activities in Kenya at the back.



First Kenyan banknotes

In 1979, following the death of H.E. Mzee Jomo Kenyatta and the subsequent inauguration of H.E Daniel Toroitich Arap Moi as the second President of the Republic of Kenya, new notes and coins with new security features were issued to commemorate the events and usher in a new era by including the President's portrait.

The new Constitution Section 231(4) requires that notes and coins may bear images that depict Kenya or an aspect of Kenya but should not bear the image of any individual. Central Bank will therefore in the near future be expected to replace the current generation of notes and coins with new currency bearing these new features. And, given the intricate process of amending the Constitution, we can be assured that these features will be with us for generations to come.

"Everyday do something that will inch you closer to a better tomorrow".
Doug Firebaugh

What is inflation?

Mention the word inflation and there are as diverse mental impressions of what it is as the number of people in the audience. It is therefore worthwhile presenting, for public understanding, financial and economic subjects in simple terms in order to converge public understanding of this topic.

High inflation adversely impacts the price of basic foodstuffs

Inflation is the continued (or sustained) general increase in the prices of items and services that the people of a given country use over a given period of time e.g when the price of maize flour which was originally costing Ksh.54 increases to Ksh.70.

Inflation occurs when financial and economic changes, actual or expected, cause the demand for goods and services to go above the existing supply at existing prices. It also occurs when supply falls below demand for goods and services e.g when there is demand for sugar yet the supply is low.

What influences inflation?

In Kenya, inflation is mainly influenced by changes in food supply, petroleum and other fuels, transport and communications. Changes in the general price level are influenced by the amount of goods and services available and the amount of money in the economy. Other factors that affect inflation include: drought, floods, wars, crop diseases, political upheavals, or other unique events take place.

CBK has an inflation target of 5 percent plus or minus 2 points. Overall month on month inflation was 5.4 percent as at January 2011. This indicates that Kenya is within the inflation target.

Government agencies conduct household surveys to identify a basket of commonly used consumer goods and services and track, over time, the prices of these items. A common price for all baskets is derived and it is referred to as the Consumer Price Index (CPI).

How does this affect the consumer?

Even though inflation sometimes leads to short-term gains, inflation eventually disrupts normal economic activities. When prices of the goods and services that we buy increase, our ability to buy them is reduced and we can only buy fewer of the same. This forces people of lower income to use less quantity or substitute with poor quality food items or adjust their budgets accordingly. This may affect their nutrition and health status, such that their labor productivity is reduced.

High inflation also affects those who earn fixed incomes such as pensioners. A parent will keep a close observation on the changes in fees in schools where his/her children attend. Likewise, high inflation limits investments by businesses and can also limit employment of labor. Investors track inflation in order to know where to invest their wealth. Policy makers and economists track inflation to decide how to manage or change economic policy or strategies. Quite often, during periods of high inflation, business spending decreases, consumer spending decreases and stock and bond prices usually depress rapidly.

Inflation is controlled mostly by central banks which control the availability and cost of credit. The volume of money in circulation influences the cost of money (interest rates). A central bank would track inflation in order to decide whether to make more money available to the public, by making it more affordable, or to make less money available, by making it more expensive. By making these adjustments inflationary pressures are partially offset. A central bank controls the amount of money in circulation to match the expected economic growth. Control of money in circulation to influence price levels is called ‘Monetary policy’. For these reasons, we need to have low, stable and predictable inflation levels to support economic growth.

Upcoming events

Business Community Visits

The Central Bank of Kenya (CBK), Kenya Bankers Association (KBA) and the Kenya Credit Information Sharing Initiative (KCISI) will jointly undertake sensitization forums (Business Community Visits) in Kisumu, Eldoret and Mombasa in February and March 2011. The visits are aimed at sensitizing the customers and staff in these towns, and the general public on the benefits of credit information sharing including full file reporting.

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Housing Finance Course by Wharton School

A Housing Finance course targeted at Sub-Saharan Africa will be held at Kenya School of Monetary Studies (KSMS) in 11-15th April, 2011. The course will be run by the Wharton School which is part of the University of Pennsylvania.

Word for word

"The Central Bank of Kenya is optimistic that the financial inclusion gap will be significantly narrowed, through usage of DTMs bringing Kenya closer to achieving the Vision 2030 objective of economic growth, development and financial stability.

The Central Bank reiterates its commitment to the development of an all inclusive financial system to serve a majority of the Kenyan populace and remains ardent in formulating policies that support innovation in the financial sector".

Central Bank Governor, Prof. Njuguna Ndung'u After Licensing The Fifth Deposit Taking Microfinance (DTM) Institution – Remu DTM Limited

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"Get to know counterparts in other countries so that it will open up and expedite communication channels that, in turn, will help you learn from each others' experiences in the march toward greater financial inclusion".

Alfred Hanning, Executive Director, AFI in his opening remarks during the The 2010 AFI Global Policy Forum

"Together with the central bank we are working on a process of financial inclusion by mainstreaming into the formal sector some people who are actively engaged in the informal sector. This will allow us to capture a lot of people who are not being included in the formal statistics that we are currently using."

Finance Minister, Uhuru Kenyatta At African Finance Ministers News Conference During IMF-World Bank Annual Meetings

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"We, Leaders of the G20, are united in our conviction that by working together we can secure a more prosperous future for the citizens of all countries. Today, the Seoul Summit delivers: the Seoul Action Plan composed of comprehensive, cooperative and country-specific policy actions. The Plan includes our commitment to: The Financial Inclusion Action Plan, the Global Partnership for Financial Inclusion and a flexible SME Finance Framework, all of which will significantly contribute to improving access to financial services and expanding opportunities for poor households and small and medium enterprises".

The G20 Seoul Summit Leaders' Declaration November 11-12, 2010